Brief in Support of Cross Petition

A true appraisal of the Opinion of the Circuit Court of Appeals filed as the basis of its decision in this Proceeding which the Railroad Company asks be reviewed by this Court must start with the premise that the Circuit Court of Appeals, notwithstanding the reversal of the District Court and its reference of the proceeding back to the Interstate Commerce Commission has, with a single possible exception, given its unqualified legal approval of the Plan of Reorganization substantially as certified to the District Court by the Interstate Commerce Commission. The Court, after referring to the decisions in *Consolidated Rock Products Company* v. *Du Bois,* and *Case* v. *Los Angeles Lumber Products Company,* 308 U. S. 106, says:

> "* * * We find nothing in either case which would defeat the plan here in question, *provided the evidence, and necessary findings are made, based on such evidence, and they establish the fairness of the plan.*" (Our italics.) (Tr. 2308.)

It is obvious, therefore, that the proceeding is to be sent back, not to conform the *Plan* to the fundamental requirements of the decision of this Court in *Consolidated Rock Products Company* v. *Du Bois,* but merely for the purpose of revamping the record and underlying data to meet the procedural requirements of that decision; and, in the *Per Curiam* Supplemental Opinion filed January 12, 1942, the Court even relaxes those requirements to the extent of dispensing with any specific Finding of the value of the Railroad Company's property as a whole.

Again in dealing with the provisions made in the Plan for the General Mortgage Bonds, the Circuit Court of Appeals says:

"Accepting, as we do, the necessity for a drastic reduction in indebtedness and interest requirements and realizing that each of these divisions, to a certain extent, depends upon the existence and business of other branches of the system, we are unable to say the evidence fails to establish the fairness of the plan so far as these bonds are concerned.

If the proposition were an original one, it is true, we can readily see how a larger percentage of the new plan first mortgage bonds might have been given to holders of the General Mortgage bonds. On the other hand, while there is a difference in the priorities of the first mortgage bonds and the Series A bonds of the new issue, this may be made up in increased interest rates of the new bonds, especially if the increased revenues of the company, as disclosed during the year 1941, are maintained even in part. There is, however, in our opinion, a serious question presented due to the small percentage (25%) of the First Mortgage bonds given to the holders of old General Mortgage bonds. Our suggestion is that if any revision should be made, this percentage might be increased and the percentage of Series B and preferred and common stock, reduced" (Tr. pp. 2312, 2313).

So we think it quite clear that the Circuit Court of Appeals has approved as lawful the Commission's Plan notwithstanding repeated references in its Opinion to the decision of this Court in *Consolidated Rock Products Company* v. *Du Bois,* and its direct admonition that the Findings which it directs "must be so specific that the court may definitely see that in the new plan, provision for full compensation of cancelled old senior securities, and all prior preferred positions, is made" (Tr. 2315). This language is manifestly meaningless when, as noted in the prefixed Cross Petition, the Plan of Reorganization shows upon its

face that the Railroad Company's General Mortgage Bondholders and Fifty Year 5% Mortgage Bondholders (we quote Mr. Justice DOUGLAS) "have received an inferior grade of securities, inferior in the sense that the interest rate has been reduced, a contingent return has been substituted for a fixed one, the maturities have been in part extended and in part eliminated by the substitution of a Preferred Stock and their former strategic position has been weakened" and not only has "full compensatory provision" in respect of "those lost rights" not been made; but no compensation whatever has been suggested unless it be the Court's vague suggestion that higher interest rates might be placed upon the new Bonds.

That the treatment so accorded the General Mortgage Bonds and the Fifty Year 5% Mortgage Bonds, whose rights are prior in all respects to the Adjustment Mortgage Bonds, runs counter to the decision of this Court in *Consolidated Rock Products Company* v. *Du Bois* cannot seriously be questioned unless the foregoing as well as the following language from the opinion of Mr. Justice DOUGLAS means something quite different from what it plainly says (the words within the parentheses being our own interpolations):

> "* * * Clearly, those prior rights are not recognized, in cases where stockholders (or junior creditors) are participating in the plan, if (senior) creditors are given only a face amount of inferior securities equal to the face amount of their claims. They must receive, in addition, compensation for the senior rights which they are to surrender. If they receive less than that full compensatory treatment, some of their property rights will be appropriated for the benefit of (junior creditors or) stockholders without compensation. That is not permissible." (pp. 528, 529).

The Plan in almost every major adjustment involves a wholly inadmissible inequality or other violation of the priorities both relative and absolute, all of which are impliedly if not expressly sanctioned by the Opinion of the Circuit Court of Appeals; and, unless this Court intervenes to settle the law, these infirmities are almost certain to reappear in and to invalidate such substitute Plan as a bewildered Interstate Commerce Commission shall hereafter formulate.

It may be admitted (and counsel would be lacking in the candor due this Court if they failed to admit) that the doctrine of absolute priority as asserted by the Court in *Consolidated Rock Products Company* v. *Du Bois* extends that doctrine beyond what we had theretofore assumed to be its fixed boundaries. Our assumption had been that it was permissible to allot junior lien bonds or even preferred stock in adjustment of senior debt and to reduce interest or convert fixed interest into contingent interest without making compensation therefor so long as the priority as regards future income was protected and preserved. It seems evident that we had misconceived the rule but even if there has been an extension or broadening of its application, the development is a salutary one in the direction of greater protection of property rights and more scrupulous respect for the inviolability of contract.

The Railroad Company accepts in its full vigor and with all of its implications the decision of this Court in *Consolidated Rock Products Company* v. *Du Bois*. As a just corollary it asks that it and its security holders in the order of their rights and priorities be given all of the benefits implicit in that decision.

To give adequate compensation to the various issues of Mortgage Bonds whose sacrifices are as extreme as those here indicated places what manifestly is a heavy burden upon the Railroad Company's Preferred and Common Stock.

The Railroad Company is nevertheless prepared to assume that burden.

In spite of the pessimism which permeates the Opinion and Supplemental Opinion of the Circuit Court of Appeals and which reflects the shaken morale of the two Groups who for reasons it would be interesting to trace are supporting the Commission's Plan, the Railroad Company maintains that rail transportation is not a decadent industry but is on the contrary an industry conspicuously on the upgrade, an industry achieving results in operating economy and efficiency of a character and extent until recently unthought of even by its own experts. This is graphically shown by the figures in the Transcript and is given striking emphasis by the current published figures of all Class 1 Carriers—figures of which this Court will, we believe, unhesitatingly take judicial notice under authorities hereinafter cited.

Let us, in developing this idea, first point out what is disclosed by the Report of the Interstate Commerce Commission as the basis of its negative Finding that the Preferred Stock and Common Stock was without value.

After showing that the present cost of reproduction new and less depreciation and the original cost of the Railroad Company's properties and its investment therein and its value for the rate base under Section 19A of the Interstate Commerce Act all exceeded by wide or substantial

margins the amount of its indebtedness, the Interstate Commerce Commission said:

> "* * * The total debt of $626,926,331 corresponds approximately to an available income of $28,212,000 capitalized at the low rate of 4½ percent. Only in 1928 and 1929 was such earning power demonstrated. We think that the examiner erred in finding a prospective equity for the preferred stock on the basis of $24,459,932 of average available income during the period 1925-29. That amount exceeds the annual charges on the principal of the present debt but does not take into consideration the large accrual of unpaid interest; in addition, it greatly exceeds the amount earned in any year since 1929. Computations were made by counsel for the committee and introduced at the oral argument showing the interest charges on the total debt at more than $29,000,000 a year. We disagree with the debtor in its contention that the high earning power of the system only 10 years ago indicates the injustice of resolving all uncertainties for the future in such a manner as to forfeit the stock. There is no evidence whatever to indicate that a recovery of the earning power of 1928-29 is reasonably probable, and we regard it as a remote possibility only, which may not be utilized to support a finding that the debtor's stockholders have an equity. In view of the earnings situation it would be improper to give controlling weight to the fact that the indicated reproduction—cost value of the property exceeds the amount of debt. We find that the equity of the holders of the debtor's preferred stock and its common stock has no value and the holders of claims in classes 24 and 25, therefore, are not entitled to participate in the plan" (Tr. 2259, 2260).

From this it is clear that the Interstate Commerce Commission attempted no Finding of value and did not make

any effort, as this Court's opinion in *Consolidated Rock Products Company* v. *Du Bois* plainly indicates is imperative, "to value the whole enterprise by a capitalization of prospective earnings." All that the Interstate Commerce Commission did was to venture a guess that a recovery of the earning power of 1928 and 1929 was not likely to occur. Nor was there even a Finding as to the amount of the annual fixed and contingent interest ahead of the stock at the date of the Plan, a factor without which the existence or non-existence of value for the stock could not possibly be determined. The importance of this is apparent when the status of $79,550,055 of interest accrued but unearned on the Adjustment Bonds is left undetermined. In interpreting the Opinion of this Court in the *Consolidated Rock Products* case, the Circuit Court of Appeals seems to have assumed that unearned contingent interest should be excluded (Tr. 2308, clause (b)).

The Railroad Company respectfully submits that this proceeding should be referred back to the Interstate Commerce Commission under subsection (e) of Section 77 with an absolute and unconditional right on the part of the Railroad Company and any party in interest to file a new Plan and to support such new Plan with additional up to date evidence: and it respectfully challenges the power or right of the Circuit Court of Appeals to refer the proceeding back to the Interstate Commerce Commission under a mandate such as is proposed in its *Per Curiam* Supplemental Opinion purporting to give the Interstate Commerce Commission an unreviewable discretion to refuse to receive evidence which parties in interest may see fit to offer in the protection of their property rights. But, assuming for argument that the Circuit Court of Appeals does possess such power or right, we again respectfully

submit that its exercise in this proceeding was so unreasonable, so erroneous and so in conflict with controlling decisions of this Court as alone to justify the issue of a *writ of certiorari* under Rule 38 of this Court.

The effective date of the Plan is December 31, 1938. The last hearing in the Interstate Commerce Commission was March 22, 1938. The final submission to the Interstate Commerce Commission was on April 12, 1939, and the original Plan was released by the Interstate Commerce Commission on February 12, 1940 (Tr. 692-1158; 2153-2269).

This Court will, as we confidently believe, take judicial notice of two facts of great significance, first, that the evidence before the Interstate Commerce Commission was closed at the very lowest point of the economic recession which set in late in 1937 and that since that time railway earnings have increased progressively until they have reached a point unprecedented in the history of the industry.

In the case of *Atchison, Topeka and Santa Fe Railroad Company* v. *United States,* 284 U. S. 248, this Court said:

> "There can be no question as to the change in conditions upon which the new hearing was asked. Of that change we may take judicial notice. It is the outstanding contemporary fact, dominating thought and action throughout the country. As the Interstate Commerce Commission said in its recent report to the Congress, 'a depression such as the country is now passing through is a new experience to the present generation.' The Commission also recognized in that report 'the very large reductions in railroad earnings which have accompanied the economic depression,' and stated that 'the chief cause

> of these reductions has been loss of traffic.' For 'in such depressions the railroads suffer severely.' Their traffic is a barometer of general business conditions'' (p. 260).

If, as is here held, the Court will take judicial notice of the existence of a depression and its reaction upon the business and revenues of our railway transportation system, it must follow that it will take judicial notice of the ending of that depression and the vast economic changes underlying the present day unprecedented prosperity of our railways.

In the case of *Central Kentucky Natural Gas Co.* v. *Railroad Commission of Kentucky, et al.*, 290 U. S. 264, the Court reiterated the above rule and held that judicial notice may be taken of changes in values, costs of service, consumption of commodities, and reasonable return on invested capital which have taken place during the period in which a case is pending before a commission and in a District Court.

For the very restricted purpose of a Supporting Brief upon application for a *writ of certiorari,* it will be sufficient to limit the discussion to the earnings of the Railroad Company for 1941 and the month of January, 1942. As already pointed out, the Interstate Commerce Commission wiped out the Preferred Stock and Common Stock of the Railroad Company because it regarded as remote a recovery of the earning capacity shown in 1928 and 1929.

Let us consider this in the light of what has since happened.

In so doing we ask the Court to bear in mind that earning capacity consists of at least two factors—(1) the capacity to attract tonnage to the rails that will produce gross receipts or (as termed in railway accounting) Railway

Operating Revenues, and (2) the capacity to convert or translate Railway Operating Revenues into Net Railway Operating Income, which may be less or may be more but ordinarily closely approximates the Income Available for Fixed Charges.

The Interstate Commerce Commission failed to disclose which of these factors it had in mind when it made its ill-fated guess, but that is not now material because it is quite evident that it was wrong as to both.

In 1929, when Railway Operating Revenues reached the all-time high of $171,361,385, the Income Available for Fixed Charges was $30,128,682 (Debtor's Court Exhibit No. 5).

In 1941, the Railway Operating Revenues were only $139,646,122, but the Income Available for Fixed Charges, as shown by the published reports of the Trustees, actually reached $28,939,719.* This figure is, however, believed to have been artificially depressed by extraordinary maintenance in the month of November and by the inclusion in the month of December of the entire wage increase retroactive for four months to September 1, 1941, without, of course, any offset for the increases in passenger and express rates already granted, or the increase in freight rates announced March 2, 1942. The Railroad Company would, if permitted to do so, undertake to prove in the Interstate Commerce Commission that the true figure for 1941 should closely approximate, if not exceed, the estimate referred to in the Opinion of the Circuit Court of Appeals of $31,140,683 (Tr. 2310). But it is immaterial for present purposes whether the true Income Available for Fixed Charges for 1941 was $28,939,719, as published by the Trustees, or

* Figures filed January 26, 1942, with the Interstate Commerce Commission and contemporaneously released to the Press.

$31,140,683, as estimated by the Railroad Company, or something more, because either figure is sufficient to cover *all* interest charges in the same period on the basis of any fair calculation; so that all gains in 1942 and subsequent years over 1941 will reflect the earning power or value of the Railroad Company's present stock (Tr. 2259).

Passing then from 1941 into the present year, we find that in the month of January, 1942, Railway Operating Revenues increased more than 30% over the corresponding month of 1941 with the following significant result:

NET RAILWAY OPERATING INCOME
1942 v. *1941*

*1942**	*1941*	*Increase*
$3,004,388	$1,756,422	$1,247,966

It thus appears that Railway Operating Revenues are running ahead of 1929 and that Net Railway Operating Income has increased in January, 1942, to the extent of $1,247,966, notwithstanding full absorption of the recent wage increase and without the benefit of the 6% increase in freight rates announced by the Interstate Commerce Commission on March 2, 1942. If this gain is maintained throughout the year 1942 (we think it should be greatly exceeded) the Railway Operating Income for 1942 in excess of what was earned in 1941 should amount to $14,975,592, so that the income available for dividends, assuming the full increase to be subject to the 31% Federal tax and deducting $4,642,433 therefor, will be $10,333,159, an amount sufficient to provide for the 5% dividend on $119,307,300 of Preferred Stock and to leave $4,367,794 available for 1,174,060 shares of Common Stock.

* Figures filed February 26, 1942, with the Interstate Commerce Commission and contemporaneously released to the Press.

Certain features of this truly remarkable demonstration of earning capacity ought to be emphasized. First of all, it is quite apparent that the high net income in a very large measure results not from abnormal tonnage created by the war but from vastly increased operating efficiency and to that extent is permanent. The figures speak for themselves and are conclusive. A comparison of the figures for 1929 as against 1941 has already been supplied. The property earned approximately as much in 1941 as it earned in 1929 although Railway Operating Revenues in 1941 were $31,715,263 *less* than in 1929. A comparison between 1930 and 1941 is of equal significance. In 1930, with Railway Operating Revenues of $142,569,632, the property earned $18,979,408 as Available for Fixed Charges, whereas in 1941, with Railway Operating Revenues of only $139,696,122, the property earned as Available for Fixed Charges not less than $28,939,719. These factors are of vital importance under the decision of this Court in *Consolidated Rock Products Company* v. *Du Bois* because they demonstrate beyond the possibility of legitimate controversy that "the past earnings record" which was the Commission's only guide when it determined to extinguish the stock was not "a reliable criterion of future performance" (Opinion of Mr. Justice DOUGLAS, at p. 526). For that reason, if for no other, the proceeding should, we submit, be remanded to the Interstate Commerce Commission with directions to make a thorough-going study of the causes underlying the greatly increased capacity of the Railroad Company to translate gross revenue into net income and to include the results of its study as part of the factual data supporting its valuations under subsection (e) of Section 77 of the Railroad Company's properties as a whole and by mortgage sections.

Nor can the greatly increased tonnage which is moving over the Railroad Company's rails be disregarded in an appraisal of its earning power on the theory that the tonnage is an incident of the war and hence temporary. The fact is that it is the result of changed economic conditions, the duration of which no one can forecast. The war is only one of many factors but even the war may continue far into the future. Should it, as we all hope, end abruptly, inevitably it will be followed by a rebuilding program in Europe, in Asia, and elsewhere that may reasonably be expected to put upon our rails a traffic far in excess of any that could be measured by the past. The competition of the Panama Canal which heretofore was so devastating to the transcontinental railways is no longer significant and may never be restored. The world will need a new merchant marine to take the place of what is now being destroyed—millions of tons of iron and steel will move from our great industries to shipyards in the Pacific, the Atlantic, the Gulf of Mexico and the Great Lakes. These and other obvious sources of tonnage should assure for a period at least equal to the full service life of their present rails a splendid prosperity for our rail transportation systems.

The Railroad Company respectfully submits that this proceeding should be referred back to the Interstate Commerce Commission, not only for a complete set of Findings supported by adequate underlying data giving effect to economic changes since its original Report, but also for a radical revision of the Plan of Reorganization to conform to the fundamental requirements of this Court's decision in *Consolidated Rock Products Company* v. *Du Bois.*

In order that this may be done, unclotured hearings should be held by the Interstate Commerce Commission.

All that the Railroad Company seeks on behalf of its creditors and stockholders is a fair chance at hearings of that character held under a mandate from this Court to prove in support of a fair, equitable and non-discriminatory Plan of Reorganization conforming to the requirements of *Consolidated Rock Products Company* v. *Du Bois* its vastly increased earning capacity as the basis of true valuations of its properties as a whole and by mortgage sections to the extent that earning capacity is a factor to be considered under the law of the land.

In conclusion, the Railroad Company wishes to emphasize that its position under Section 77 of the Bankruptcy Act is *quasi* judicial and that it may and does speak for and in a very large measure represent both creditors and stockholders. By the title as well as by the terms of Chapter VIII of the Bankruptcy Act of which Section 77 forms a part, the Statute is one (note Section 73) "for the relief of debtors"; but, as the very first step to be taken thereunder after the approval of the Petition, the Railroad Company, as the Debtor, is required to surrender its entire estate to one or more trustees whose appointment is made mandatory. Subject to one exception found in subsection (g) which provides for a dismissal of the proceeding if there is undue delay, the only means whereby the Railroad Company may retrieve and receive back its properties so placed in judicial custody and obtain the relief for which Section 77 provides is by securing the approval of a Plan of Reorganization which is fair and equitable, affords due recognition to the rights of each class of creditors and stockholders, is non-discriminatory and otherwise complies with Section 77. The Railroad Company is therefore just as much interested in developing a Plan that is fair and equitable to its creditors as it is in securing a Plan that

affords due recognition to its stockholders and it believes that when this proceeding is remanded to the Interstate Commerce Commission such a Plan of Reorganization giving it the relief which the Statute contemplates may readily be developed within the principles and requirements and subject to all of the limitations of *Consolidated Rock Products Company* v. *Du Bois.*

To this end it asks that a *writ of certiorari* issue in accordance with the prayer of its Cross Petition.

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